

HALTING THE CURRENT RECESSION

A Proposal for Dealing with "Sellers' Inflation"

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WHEN the United Automobile Workers International Union (UAW) recently invited the three big automobile corporations to take a first step in checking the inflationary process by lowering 1958 automobile prices, the corporations in effect replied, "After you, Alphonse." Yet the proposals and counter-proposals must be recognized as something more than sparrings for future bargaining positions. They clearly demonstrate three phenomena of the first importance: (1) a genuine concern, on both sides, with the dangers of inflation, (2) a readiness to cooperate in checking the inflation (provided that such cooperation is not exploited and diverted for the benefit of the other side), and (3) a recognition that the inflation we now have is based not on competition by *buyers* trying to buy more of everything than can be supplied, but on pressure by *sellers* asking for higher prices.

Others also have recognized that our current inflation is not the familiar kind that is caused by excess buyers' demand—by "too much money chasing too few goods," i.e. by buyers bidding up prices in trying to get more goods than the economy is able to supply. Thus President Eisenhower showed

awareness of the truth in his appeal to labor and business to exercise restraint and refrain from demanding higher wages and prices. If our inflation were indeed caused by excess buyers' demand, not only would the UAW proposals and the corporations' rejoinders be without interest, but the President's appeal would have been pointless. Free market prices would still be bid up by competing buyers, and sellers who exercised restraint would merely be making presents to the buyers (who would often be able to resell at the higher free market prices). Such an inflation could be cured only by removing the excess buyers' demand through the well-known policies of tight money and restrictive fiscal measures, and the restraint called for by President Eisenhower would be unnecessary.

But excess demand by buyers is *not* the only possible cause of inflation, and our inflation is not the kind that is caused by such excess demand. This is shown by the failure of output to keep up with growing productive capacity. It does not seem to be the case at all that we are unable to supply the current over-all demand for goods and services. On the contrary, we are able to supply more than is being demanded of almost every product, and efforts by sellers to persuade the public to buy are as strenuous as ever (though they hardly ever take the form of lowering prices, or we would not be suffering from inflation). Prices are rising not because of the pressure of *buyers* who are finding it difficult to buy. Prices are rising because of pressures by *sellers* who insist on increasing prices (even though they are finding it not so easy to sell). We may say that what we have is not a *buyers' inflation* but a *sellers' inflation*, and it is this problem that I wish to discuss.

THE United States is at present in the paradoxical situation of appearing to suffer from inflation and depression at the same time—prices are rising, while employment is declining. In this article, ABBA P. LERNER, the well-known economist and author of numerous works of economic analysis, examines the nature of what he describes as "sellers' inflation" and suggests means of countering it. Mr. Lerner is visiting professor at Johns Hopkins University, Baltimore. His article "The Myth of the Parasitic Middleman" appeared in the July 1949 number of COMMENTARY.

SELLERS' inflation, unlike buyers' inflation is compatible with depression. Prices are rising because of upward pressure by sellers, and the authorities, in endeavoring to stop the inflation, have taken steps which have been very effective in removing excess demand, but which have not removed the upward pressure on prices from the sellers' side. Indeed these measures of budgetary restraint and tight money have been so effective in removing excess demand that they have removed some demand that was *not* in excess. They have brought about a condition of *deficient demand*, so that there has not been enough demand to enable us to make full use of our productive potential. So much so that the visible appearance of symptoms of recession has recently led to a slight loosening of the tight money policy. The net result is that we are now suffering at the same time from both inflation and depression—prices are rising, and at the same time we are not fully utilizing our available labor force and productive potential.

This appears paradoxical only because of our habit of using one word, "inflation," to represent two different things—rising prices and excess demand—that do not necessarily have to go together in the actual world. We can avoid this confusion by using the word "inflation" only to mean rising prices, and saying "excess demand" if we mean excess demand.

Many people still seem to argue as if the only kind of inflation possible is buyers' inflation (which they usually call demand inflation). Although they cannot deny that they see excesses of potential supply much more often than excesses of buyers' demand, they insist that "there ain't no such animal" as sellers' inflation. They hold that "inflation is inflation," and they sternly dismiss as dodging of the necessary medicine all talk about a new kind of inflation that does not respond to the orthodox treatment of monetary and fiscal restrictions.

Unfortunately, such sternness is only too understandable. Some of the economists who were early to recognize the nature of sellers' inflation have been so impressed by the im-

possibility of dealing with it by the orthodox instruments of monetary and fiscal policy that they have capitulated to the temptation of dallying with "mild" or "moderate" inflation as part of an acceptable policy. The orthodox economists quite rightly point out that such an attitude is indefensible either on moral or on practical grounds. Even a "mild" inflation accumulates at "compound interest" and robs pensioners, fixed-income receivers, and many other unfortunate victims, while it sabotages the proper calculations and accountings necessary for wise economic decisions. In time, many of these faults could be corrected by institutional adjustments, but to keep the inflation "mild" is more difficult than to prevent it from starting in the first place, or to stop it before it gets less "mild." Firmness is required and not appeasement.

But the naughtiness of the appeasers does not diminish the importance of recognizing the existence of sellers' inflation, for it is not the *recognition* of the disease that opens the gates to the enemy. On the contrary, it is the denial of its existence that is so dangerous. The belief that the medicines appropriate for buyers' inflation are the only medicines available, when joined with the discovery that these do not work, gives rise to defeatism and appeasement. A clear recognition of the nature of sellers' inflation is the prerequisite for finding the medicine that can cure it.

Another reason for reluctance to recognize sellers' inflation is that it has often been called "cost inflation" or "wage-cost inflation," thus giving the impression that the whole of the blame falls on labor or on the trade unions. When trade unions raise wages by more than can be absorbed by increasing productivity, costs rise. The employer then seems to be completely innocent of "profit inflation" in passing on the increase in costs, as long as he does not increase his rate of mark-up, i.e. as long as he does not increase the prices he charges for the product in a greater proportion than his costs have increased. There is, however, no essential asymmetry between the wage element and the profit element in the price asked for the

product. A sellers' inflation could just as well be started by an increase, not in the wage asked, but in the percentage of mark-up of price above cost. Prices would rise, and wages would then be raised by the workers in attempts to maintain (or restore) their original buying power. Business would then "innocently" raise prices again in proportion to the increase in costs, and we would have the inflation upon us, as well as a boring discussion about who started it first.

The "who started it first" debate is a waste of time because there is no "original" situation in which there was a "just" or "normal" distribution of the product between wages and profits. Any increase can be seen either as a disturbance of equilibrium or as the correction of an inequity perpetrated in previous history—all depending on the point of view. The term "sellers' inflation," by treating wages and profits on exactly the same footing, avoids the fruitless game of mutual recrimination. Sellers' inflation takes place whenever wage-earners and profit-takers together attempt to get shares that amount to more than 100 per cent of the selling price. When the sum of what they try to get comes to more than 100 per cent of the selling price, it is futile to ask whether this is because the wages demanded are too high, or because the profits insisted on are too great. No matter where justice may lie between the two claims, the only significant thing for our problem is that the sum of the claims is more than 100 per cent. That is what causes inflation.

It is of course impossible for the two parties to succeed in getting more than 100 per cent of the proceeds between them, but it is precisely on an impossibility such as this that any continuing process depends. Buyers' inflation is similarly built on an attempt to reach the impossible. In that case it is the attempt of buyers to *buy more than 100 per cent* of the goods that can be made available. Their attempt bids up prices, but since that does not (and cannot) enable them to obtain more than 100 per cent of the goods, they go on with the attempt, and we have the continuing process of buyers'

inflation. In our case, what generates the process is the attempt of wage-earners and profit-takers between them to *get more than 100 per cent* of the money proceeds from the sale of the product. Each increases the part he tries to take, by increasing wages or by increasing prices. Since they cannot succeed, they keep on raising wages and prices and so we have the continuing process of sellers' inflation.

AN INTERESTING indication of the strength of the most important element in the set-up—the general feeling of the propriety and inevitability of continuing wage and cost increases (to be "passed on" in increased prices)—is provided by the debate about automobile prices and wages which was referred to earlier. The UAW had asked the automobile corporations to reduce the prices of their 1958 automobiles to \$100 below the 1957 prices, in return for a promise to take this into consideration when presenting their 1958 demands for wage increases. In rejecting this proposal the largest of the corporations put forward a counter-suggestion which must clearly be considered as an extreme position, leaving some room for retreat (i.e. for conceding bigger increases in wages) in the forthcoming negotiations. This "unrealistically extreme" proposal, made (it must be remembered) in the course of a debate in which everyone was deeply concerned with the dangers of inflation, included the continuation of the present contract which calls for a regular wage increase of 2½ per cent per annum (apart from a cost of living adjustment). This is more than the average increase in output per head in the American economy, so that there is a significant piece of sellers' inflation right at the lower end of the range subject to negotiation. In such an atmosphere it would require a quite severe depression to change people's notions of what is the proper development of wage rates and of the corresponding prices (since the right of wages to increase goes together with the right of profits at least not to fall). It would take perhaps an even more severe level of

unemployment to destroy the power, or remove the inclination, of labor to *force* wage increases on reluctant employers who grant increases only when they feel that they are obliged to—i.e. that they would lose more from strikes than by agreeing to higher wages (and passing them on).

A policy of relatively high employment seems to have won a firm place in the country's economic policy, not only for social and international political reasons, but because neither political party can afford the blame for even a mild depression. With such a set-up there is no need to worry whether the cure is worse than the disease—whether the depression would be more harmful than the inflation that it would prevent. This cure is not one that any government would apply, or even seriously attempt to apply.

It has been suggested that even if the authorities are not really prepared to bring about the degree of depression necessary to negate the pressure of sellers' inflation, they could still do the trick by solemnly announcing a policy of refusing to provide the increase in expenditure called for by a continuing sellers' inflation. The threatened unemployment would then sober the sellers into calling off their inflationary wage and price increases. It seems pretty certain, however, that such a declaration would not be believed and that the bluff would quickly be called. Even if it were believed as regards the economy as a whole, that would not prevent any specific wages or prices from being raised while local conditions still permitted this. It would perhaps even aggravate the wage and price increases, as each tried to get his increase quickly while the local going was still good.

All this brings us to the perhaps only too obvious conclusion that sellers' inflation cannot be cured or prevented by measures directed against excess demand by *buyers*. It can be successfully treated only by attacking the pressure on prices by *sellers*.

THE present debate in the automobile industry indicates where the solution may be found. Workers feel that if they exercise

restraint in their wage demands this would only increase the residual going to profits, while employers feel that if they *should* lower the price they charge for the product, wages would not be reduced proportionately; so that, instead of a general benefit from the avoidance of inflation, with everybody gaining and nobody losing, there would be an unjustified or even an intolerable transference from profits to wages.

This was admirably brought out by the Ford Company which, in its reply to the UAW, turned the UAW proposal completely around and proposed, with more sarcasm than seriousness, that "if you will accept an immediate reduction in wages to the level prevailing at the introduction of our 1957 models, we will take this into consideration in determining how much we will increase prices in our 1958 models." In effect each side says, "You take the first step and trust me to play fair and do my part too." Such invitations are as futile as proposals for unilateral disarmament in another field—and for the same reason: neither party trusts the other not to exploit the opportunity offered to it. Agreement can be reached, if at all, only if there is a clear definition of what is to be done by *both* parties, and if neither party loses, but both gain from a fair arrangement.

In the negotiations that take place between employers and labor, agreements are reached which are both clearly defined and mutually agreeable. But in the course of reaching such agreements, the objective we are concerned with here—the avoidance of inflation—is lost. Both sides recognize that everybody would be better off if inflationary increases in all wages and in all profits were avoided. Real wages and real profits would not be lower but rather higher, to the degree that the economy was saved from inflationary damage. But each party tries to increase or protect its share by asking for more, and not by insisting on less for others. Each party is, furthermore, represented by negotiators who have to show they are earning their keep by pressing as hard as possible to increase their party's share, so that

there is a balance of upward pressure on the prices demanded. The result is sellers' inflation.

This does not happen in a perfectly competitive market, because under such conditions there are not present the institutions and attitudes that give sellers the power to push prices up. In a perfectly competitive market, all that is needed for price stability is a monetary and fiscal policy that keeps buyers' demand from becoming either excessive or deficient. No one holds back any product from the market—or can establish a price which results in some of the potential product or the available labor not being taken off the market, so that unless there is excess buyers' demand, prices cannot rise, and if there is a deficient buyers' demand, prices must fall. Unless there is full utilization of resources we cannot have inflation, and if there is a depression (or recession) we will have *deflation* (i.e. *falling prices*).

Thus in a perfectly competitive economy we cannot have inflation and depression at the same time. But where prices are administered by the decrees of large firms, and wages are administered by joint decrees of powerful unions together with powerful employers or employer groups, the situation is different. Sellers' inflation is a by-product of the process, and together with sellers' inflation we can also have depression—indeed we will have depression if the authorities try to cure inflation by reducing ("excess") demand.

These by-products of administered wages and prices have important similarities to, and are no less socially harmful than, the monopolistic exploitation that would result from the administration of excessive prices by public utilities. We have gone a long way toward eliminating the latter evil by the *regulation* of prices that may be set by public utilities for the services they supply. The same kind of device can be used to eliminate other evils. Just as public utility prices can be, and are being, regulated so as to prevent monopolistic exploitation, so administered prices and wages can and should be regulated so as to prevent sellers' inflation and

the depression which it may bring with it.

THE regulation of administered prices and wages so as to prevent sellers' inflation would have to follow somewhat different lines. It would not be directly concerned as to whether there is more or less than a "fair" rate of return on investments. That would be left to the strong competitive forces which still prevail in our economy. Nor would any regulations be involved other than *price regulations*. The function of the regulation here proposed would be to prevent *restrictive* prices or wages from being administered. A restrictive price is one that results in the demand for a product falling below capacity output. A restrictive wage is one that results in less than full employment in the specific labor market to which it applies. With a monetary and fiscal policy concentrating on the maintenance of adequate buyers' demand for full employment at a constant price level, while preventing buyers' inflation, it would be possible for wages per hour to rise on the average at the same rate as productivity per hour, with aggregate profits rising too at the same pace as aggregate wages and aggregate output (except that increases in the degree of competition, which might be induced, could reduce the share going to profits and increase the share going to labor).

The regulatory body would therefore have to follow a set of rules which would do the following things:

1. They would permit an administered price increase only when production and sales are at capacity. Such price increases should not be withheld on account of profits being high.
2. They would enforce decreases in administered prices whenever production and sales are significantly below capacity. A price decrease should not be waived on account of profits being low, or even negative on this item in the firm's output, as long as the price more than covers current operating costs (more strictly short-period marginal costs).
3. They would permit increases in administered wages, in general at a rate equal to

the average trend of increase in national productivity.

4. They would permit increases in administered wages greater than this wherever the labor market is tight—with, say, less than half the national average rate of unemployment.

5. They would permit only smaller increases in administered wages, or no increases at all, where the labor market is slack—with, say, more than twice the national average rate of unemployment. (The expected continuing increase in product per head makes it possible to avoid reductions in money wages, although it is unavoidable, for price stability, that some prices must fall if others rise.)

This is of course not a fully worked-out solution ready for immediate application. Much remains to be developed—such as generally acceptable criteria of the capacity of different firms and industries, and generally acceptable measures of slackness or tightness in particular labor markets. Measures must also be considered for dealing with possible attempts by monopolistic industries to restrict the installation of capacity if they are prevented from restricting the utilization of existing capacity. (This would bring out the existence of a specific monopoly situation that calls for treatment quite apart from the problem of inflation.) The intensification of competition which the regulation would enforce would also in some instances lead to the elimination of high-cost competitors. While the public would benefit from the increased efficiency of the economy—in higher wages and lower prices—such elimination of competition would conflict with certain existing so-called anti-trust policies that have become in effect anti-competition policies and need to be reconsidered.

The prohibition of price or wage increases could take the form of taxing such unauthorized price or wage increases at very high rates, while the stabilization of administered prices at the approved levels could be facilitated by government purchases and sales at these prices, using the device of "counter-speculation" to prevent monopolistic influences on price from causing inflation and un-

employment, just as it can be used to prevent monopolistic influences on price from interfering with the optimum allocation of resources by the competitive market.

There remain important problems of organization and administration of the regulatory body, as well as the need for widespread and intensive public discussion to bring about the kind of understanding of the proposed regulation which is essential for its effective operation in a democracy. And in the course of such examination and debate, important developments, changes, and improvements are to be expected. Nevertheless the general solution here indicated seems to be required if sellers' inflation is to be attacked at its roots.

IT is to be expected that one of the most effective debating points against this proposal will be the charge that it means *price control*, against which there are a thousand cogent arguments, as well as a powerful popular appeal. I would like to go on record as an opponent of price control myself, but *price regulation* is not *price control*. The latter consists of an attempt by authority to establish a price below that which clears the market, i.e., a price so low that the amount available is insufficient to satisfy fully the demand of all the would-be buyers. At the controlled price there is therefore *excess demand*. Buyers try to buy more than is available for them to buy. This results in disorganized supply, waiting in line, tyranny of sellers over housewives and other buyers, selling under the counter, gray markets and black markets, evasion of and disrespect for the law, corruption and gangsterism, and finally, as a lesser evil, the installation of rationing, with all its administrative burden, economic inefficiency, and public inconvenience.

Price regulation does not attempt to set a price below that which clears the market. It only prevents the public utility, or whoever else determines an administered price or wage, from setting it *above* the level that would clear the market at the optimum output. In fact, in the case of public utilities the price regulation results in greater output at lower prices and a more efficient use of the

resources of the economy. The owners of the public utility are indeed deprived of their opportunity to make monopoly profits, but that is more than offset by the consideration that the monopoly profit could have been obtained (in the absence of price regulation) only at the expense of a loss to the consumers much greater than the gain to the monopolists. Since there is no attempt to set the price below the level that would clear the market, everybody can buy as much as he wants to of the product—railway travel, electric current, or whatnot—and none of the evils of price control comes into the picture.

Price regulation is more properly seen as the *opposite* of price control. The function of a price is to clear the market. Price control is bad because it interferes with this function by attempting to establish a different and lower price which *does not* clear the market. Price regulation restores the function of price by adjusting the price so that it *does* clear the market at the optimum output. *It interferes only with interferences*, preventing the monopolists from fixing a price *above* that which would clear the market at the potential supply, which is the socially most desirable supply.

In the case of the proposed regulation of administered prices and wages, the suggested rules are specifically such as would always maintain prices and wages which would clear the market at full employment with price stability. Nowhere would this result in a price or wage below that which would clear the market, so that the cry of "price control" would be no more justifiable than if raised against the established policy of regulating the price of water supply or telephone service—perhaps even less justifiable, since regulation of the prices charged by public utilities does prevent these from obtaining monopolistic gains, while the proposed regulation of wages and prices would only prevent the inflation from which practically nobody gains.

The full utilization of existing capacity may sometimes lead to inadequate profits, or even to losses, but that is the nature of the competitive profit *and* loss system. It shows

that an error was made in the past in producing too much capacity in the industry, but that is no reason for society's compounding the error by refusing to make use of the capacity once it has been produced. The low profits or the losses are then performing their proper function of discouraging further investment in such industries. In other cases the prices that clear the market at full capacity output will yield very large profits. These large profits are then performing their proper function of encouraging more investment in such industries (unless there is a monopolistic restriction on such investment, which would call for anti-monopoly action or price regulation in the corresponding investment industries).

JUST as low profits form no excuse for monopolistic restriction of output, so the high profits are no excuse for enforcing price reductions below the level which clears the market. This *would* be price control and is to be equally condemned whether it is imposed by government or whether it is due to "restraint" on the part of producers who are powerful enough, and rich enough, to be able to do this. If the existence of excess capacity in steel and in automobiles means that current prices are set too high, the emergence of gray and black market prices during and after World War II meant that prices were then too low. The generosity of the corporations at that time in selling too cheap (in part to privileged suppliers of the black market) is no justification for selling too dear now. A genuine defense of the free market system is not affected by the emergence of either profits or losses.

Another objection I would like to anticipate is that the regulation of administered prices and wages, so as to prevent sellers' inflation, is in conflict with the traditions of free competitive capitalism. It is possible that the trade unions would easily see all the social benefits to be gained from keeping the prices of products down to the level needed for capacity production and full employment, but would denounce the regulation of wages as an intolerable interference with the fun-

damental right of collective bargaining. It is possible that employers would quickly appreciate the desirability of curbing excessive wage demands, but would reject the regulation of prices as an alien and unthinkable interference with the free economy and an impious infringement of the sacred rights of management in setting prices.

Such responses would indicate that "after you Alphonse" really means "include me out," or "let George do it," and we will not have the cooperation that is necessary. The true interests of labor are not damaged by the trade unions relinquishing the right to institute inflation, or even by their giving up the right to use inflation as an instrument for attempting to increase real wages at the expense of profits. The true interests of capital are not betrayed by surrendering the parallel right to start (or keep feeding) a sellers' inflation by restricting output below capacity so as to raise prices (or by raising prices where this has the effect of restricting demand and output below capacity).

The justification of the free economy and its institutions rests ultimately on its efficiency in satisfying the needs and desires of a free people. The price mechanism is the central instrument for approaching such optimum output, and it does this only to the extent that the prices (including wages) are those that clear the market, while corresponding to the value of the alternative products that have to be sacrificed (at the margin) in order to produce the current output of any commodity or service. Monopolistic restriction of output causes resources to be shifted from the production of more useful to the production of less useful goods and services. The regulation of public utility prices is justifiable because it works in the desirable direction of correcting this distortion. Inflation damages the economy as a whole. The restriction

of output that results from attempts to curb sellers' inflation by reducing buyers' expenditures is more damaging than monopolistic restriction. The latter shifts resources from useful products to less useful products, while the former shifts resources from the production of useful products to producing nothing at all—except the human frustrations and suffering from unemployment. The regulation of prices and wages that is necessary to prevent sellers' inflation is therefore more important than the regulation of naturally monopolistic public utilities, and no more repugnant to the basic principles of the free society.

In this spirit the proposals here made will be seen not as infringing the principles of the competitive profit and loss system, but as protecting this system from the power of sellers to raise prices and wages above the levels compatible with full employment and price stability. He is not a true friend of the free society who defends these flaws that permit inflation and unemployment to persist.

It has been very fashionable for some time to deplore inflation and to quote Lenin's declaration that inflation is the Achilles heel or the Trojan Horse of capitalism. Recently it has become even more fashionable to *preach* restraint, as a remedy for inflation, to parties who are unable to respond, even if willing, because they have no assurance that the others will play their part. The most recent statements by Labor and Management in the automobile industry include public declarations of conversion to a readiness to exercise the restraint, provided the other parties cooperate. The time has come to wind up the deploring, the quoting, the preaching, and the declaration of conversion, and instead, by regulating administered prices and wages, to *provide* the restraint needed to protect the free economy from sellers' inflation.